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Dispute Boards, Resolution and Avoidance of Disputes in Construction Contracts

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Dispute Boards
Resolution and Avoidance of Disputes in
Construction Contracts

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1. Concept and History

Construction contracts are typical of incomplete contracts because it is not possible to describe all contingencies which may, or may not, occur during the course of construction. To cope with those contingencies, most standard forms of construction contracts provide rules for 1) Risk Sharing, 2) Variation (Change) and 3) Dispute Resolution. A mere difference of opinions of the parties in the interpretation of the contract documents often develops to a serious dispute. If the parties fail to settle the dispute by negotiation, they may go to arbitration or litigation. Every party wants to avoid arbitration or litigation because they know arbitration and/or litigation take time and need substantial expenditure. Moreover, in arbitration and litigation, the relationship between the parties gets worse and the project cannot be completed successfully (and someone will lose face in the end!).

The best way to resolve disagreement is to prevent it from becoming a formal dispute. The primary duty of a Dispute Board (“DB”) is to avoid disagreements becoming disputes. Making a decision or “Recommendation” is a secondary role of the DB.

A DB is made up of three (or one depending on the size and complexity of a project) members who are experienced in and knowledgeable about the type of the construction, interpretation of contract documents and the DB process and are absolutely independent and impartial. A DB is set up at the outset of a project and the DB Members are to be given the Contract Documents such as Conditions of Contract, Drawings, Specifications and Programme so that the Members can be conversant with the project. The DB visits the Site regularly, say quarterly, to meet the Site people and to observe the progress and problems, if any, of the project. Between the Site visits, the Engineer or the Parties send the DB Members the Monthly Progress Report, Claim Notices and other important correspondence to keep the Members informed. The DB is part of the construction team who assists the parties in avoiding claims and settling disputes by amicable negotiations. If the parties fail to settle disputes, they are referred to DB for determination. Since the DB members are familiar with the contract

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documents and the Site operation and progress of the project, it will not take much time to judge the dispute. Even if the determination is rejected by one or both parties, it will be the basis for further negotiation in an amicable manner. Thus, the benefit of DB is prevention of disputes and early settlement of disputes without embedding adversarial attitudes.

The concept of DB was established during the use of “a four-person joint consulting board” in the Boundary Dam and Underground Powerhouse Complex Project in the mid-1960s in Washington State and the tunnelling industry first used the DRB (Dispute Review Board) process in 1975 during construction of the second bore of the Eisenhower Tunnel in Colorado. It was an overwhelming success; The DRB heard three disputes during construction and the DRB Recommendations were accepted. All parties were pleased at the end of the project. In 1980 World Bank promoted a DB (then called “Claims Board”) on El Cajon project in Honduras, which was also successful¹. In 1995 World Bank Standard Bidding Document published modified FIDIC² conditions which deleted the usual provision of the “Engineer’s Decision”, giving this task to a DRB.

2. Statistics

The graph, **Fig-1**, shows the statistics of the use of DB from 1982 to 2004. The readers may recognize how DB process has grown over the last decade. Please note that the statistics was made mainly based on the reports from North America and it is assumed that more projects have used DB internationally under FIDIC Conditions of Contract.

In three mega projects, Channel Tunnel/Train/Terminal (UK-France), Hong Kong Airport (HK) and Ertan Hydro Project (PRC), DBs were used successfully.

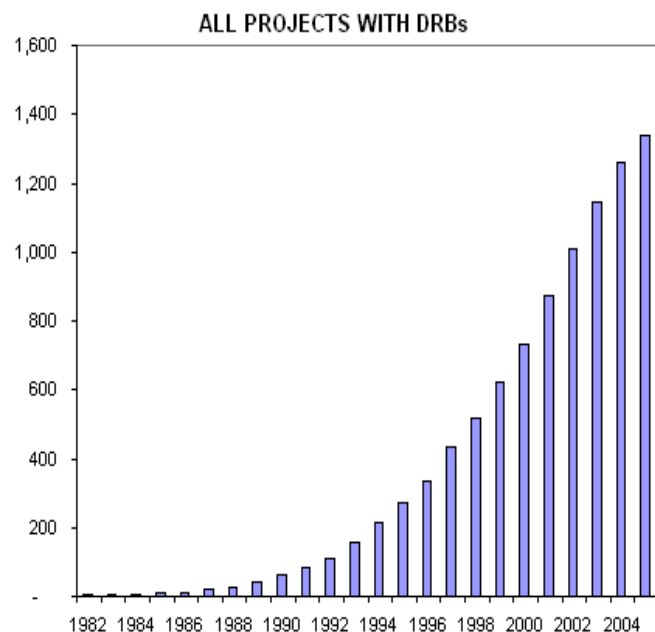


Fig-1

¹ The late Mr. Al Mathews, who was involved in both Boundary Dam and Eisenhower Tunnel projects, persuaded the Contractor and the Government to use a DB in El Cajon project. He was the founder and the first Chairman of the Dispute Resolution Board Foundation (DRBF), Seattle, Washington, USA

² Fédération Internationale des Ingénieurs-Conseils (International Federation of Consulting Engineers)

3. DRB, DAB and CDB

There are three principal types of DBs, the Dispute Review Board (“DRB”), the Dispute Adjudication Board (“DAB”) and the Combined Dispute Board (“CDB”).

(1) DRB

The DRB has been, and is, used in the US widely for these three decades and the dominant form there. Internationally the World Bank also provided for DRBs in the January 1995 and subsequent editions of its Standard Bidding Document, *Procurement of Works*, and continued use until the May 2000 editions, when it adopted the DAB type. The DRB continues in use under ICC Dispute Board Rules. The DRB issues a Recommendation. Either party may express its dissatisfaction with the Recommendation by issuing a notice then the parties may continue negotiations or a party can invoke arbitration or go to court (arbitration is most commonly used in the international business transaction). If no party expresses dissatisfaction within a specified time, the Recommendation becomes binding. It is said that a Recommendation of DRB does not “dictate” to the parties and therefore, is more likely to be the basis for amicable settlement without jeopardizing the parties’ good relationship.

(2) DAB

The DAB issues a decision on the matter of dispute, which is binding on the parties as soon as it is issued. It currently is the most common form of DB used in international construction contracts. The parties must comply with it without delay notwithstanding a party’s expression of dissatisfaction. Depending on the DAB provisions in the conditions of contract, the parties may renegotiate the issues, or the unsatisfied party may invoke arbitration immediately. Even if objected to, the decision of the DAB is binding until and unless the parties agree otherwise or the arbitral tribunal decides differently. Some people argue that DAB is appropriate to the international projects which have multinational business cultures. Both *FIDIC 1999 Conditions of Contract* and *FIDIC MDB (Multilateral Development Banks) Harmonised Conditions of Contract* provide for DAB although a DAB is called simply DB” in the *MDB Edition*.

(3) CDB

The CDB is a unique Board which the ICC³ introduced in 2004. As the name shows, it is a process combining DRB and DAB. The aim of the new creature is to combine the advantages of two basic

³ International Chamber of Commerce, this rule was developed by ICC International Court of Arbitration.
<http://www.iccwbo.org>

types of DBs, i.e., DRB and DAB; DRB issues a Recommendation and DAB issues a decision.

The CDB operates normally as DRB. However, a party may sometimes need to have a decision with which the parties will comply immediately even if they wish to challenge it in arbitration. What is such an occasion when a party requires an immediate decision? A party may go into bankruptcy if it does not receive claimed payment immediately. A party wants the other party to stop using its know-how illegally or not in accordance with their licensing agreement because the damage may become irreversible if compliance has to await a long arbitration. A party may be facing an imminent threat that the other party will call a performance bond for a large sum of money, to the immediate and severe detriment of the party which has given the bond.

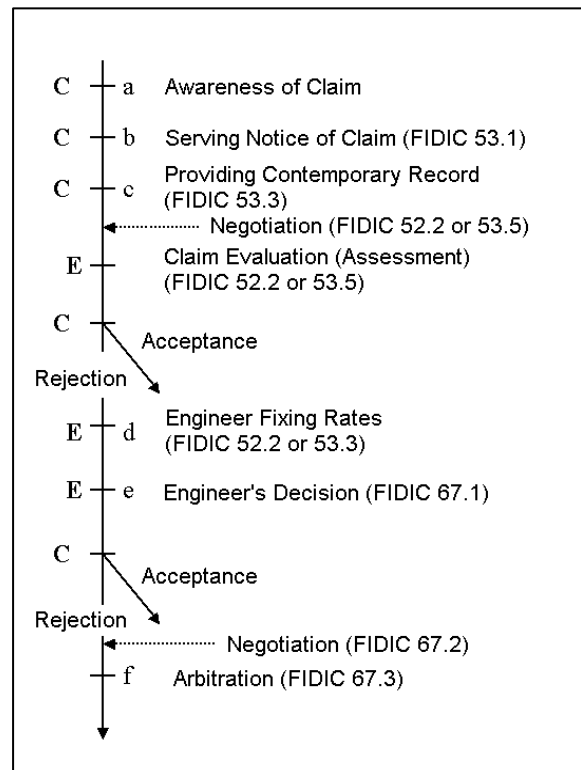
In deciding whether to use a DAB approach instead of a DRB approach, Sub-Article 6.3 of the ICC Rules provides that the CDB shall consider, without being limited to, the following factors:

- whether, due to the urgency of the situation or other relevant considerations, a Decision would facilitate the performance of the Contract or prevent substantial loss or harm to any Party;
- whether a Decision would prevent disruption of the Contract, and
- whether a Decision is necessary to preserve evidence.

Under the ICC Rules, when a party requests a decision by DAB and another party objects, the CDB has the power to determine whether the reference should be dealt with acting as a DRB or a DAB. The rule is silent as to any time limit by which the Board must determine which process, DRB or DAB, should be applied, but presumably it would be early in the formal dispute procedure.

The readers must have noticed that ICC DB Rules are quite suitable for any type of long term contract such as a licensing agreement, a sole agency agreement etc. because ICC Rules are “stand-alone”⁴ In fact, it is reported that a few contracts in the IT industry have adopted this CDB.

⁴ Christopher Koch in his presentation at the DRBF 8th Internat May 2008, used this terminology to compare ICC Rules and FID. DAB rules as integral part of the conditions.



**Fig-2: Claim and Dispute Procedure
Under FIDIC Red Book 4th Ed.**

Also, the ICC has adopted it for dispute resolution under the ICC Model Form of Major Projects.

4. Engineer's Decision and DAB in FIDIC Conditions of Contract

The Engineer, stipulated in the FIDIC Red Book up to 4th edition 1987⁵, plays two roles (Dual Role); on the one hand he acts on behalf of the Employer as his agent to administer the contract, and supervise the Works, on the other hand, he certifies the progress, fixes the rates and prices of varied works and evaluates claims as an impartial professional (quasi-adjudicator). The Engineer is required to make an "Engineer's Decision"⁶ on a dispute between the Contractor and the Engineer/Engineer's Representative or the Employer (see **Fig-2**). Thus he is expected to facilitate the dispute resolution effectively.

It is often observed in the operation of FIDIC contract that the latter role of the Engineer is not functioning properly and that a dispute goes on to arbitration. This is because the Engineer often is employed by the Employer throughout the project from the outset as a consultant to carry out the feasibility study, designing, preparation of the tender documents and evaluation of each tender to award the contract. It is quite understandable that it is very challenging for the Engineer to play the Dual Role properly; not only has to try to be objective in evaluating possible errors or omissions in the design phase, but also balance his duty to be "impartial" (under the 4th Ed of the Red Book) when acting as Engineer, he must judge his own actions or inactions. Even if his role as Engineer is not the basis of a claim, he nevertheless is in the uncomfortable position of trying to give judgment between two parties: (1) his valued client, the Employer, from whom he may hope to receive further work in the future; (2) the Contractor, who if his claim succeeds may cause delay or cost to that valued client, the Employer. In order to resolve this dilemma, FIDIC has restructured its Red Book as well as Yellow⁷ and Silver⁸ Books in 1999, by replacing the Engineer's Decision with the DAB process.

5. Establishing and Operating a DB

5.1 Timing

It is often the case that the land acquisition of the construction Site has not been finished, that the right of way to the Site has not been acquired, that the Drawings for construction have not been delivered to the Contractor timely, the mobilization of the construction equipment has not been

⁵ *Conditions of Contract for Works of Civil Engineering Construction*

⁶ *Clause 67; Settlement of Disputes*

⁷ *Conditions of Contract for Plant and Design-Build*

⁸ *Conditions of Contract for EPC Turnkey Projects*

complete by the planned date and so on. Thus, problems and difficulties often occur from the very beginning of a project which have adverse effects to the progress of the contract and perhaps the entire project. The purpose of a DB is to prevent formal disputes from arising by helping to resolve disagreements before they escalate to formal disputes, if arise. Therefore, it is obvious that a DB should be established at the outset of a project to fulfil its purpose. Yet, FIDIC 1999 Yellow Book and FIDIC 1999 Silver Book provide for an “ad-hoc” DB, established after a dispute has arisen. From the author’s point of view, the “ad-hoc” DB loses the principal value of the DB concept.

5.2 Qualifications of DB Members

FIDIC Conditions of Contract, ICC Dispute Board Rules and the DRBF⁹ Manual describe similar qualifications or required attributes of DB members. The following are the ones specified in DRBF Manual:

Quote:

When nominating prospective Board members, the contracting parties should recognize the following necessary attributes:

- Complete objectivity, neutrality, impartiality and freedom from bias and conflict of interest for the duration of the contract.
- Dedication to the objectives and principles of the DRB process.

In addition to these attributes, the parties must evaluate the experience and qualifications of the prospective members for the specific project, with respect to:

- Interpretation of contract documents
- Resolution of construction disputes
- The type of construction involved The specific construction methods to be used
- The dispute-prone facets of the work

Unquote

Each DB member warrants that he/she meets the requirements for the duration of the contract, and shall declare any change which may arise.

⁹ *Dispute Resolution Board Foundation, Seattle, Washington, USA, <http://www.drb.org/>*

5.3 Selection of DB Members

According to FIDIC 1999 Red Book, each of the parties shall nominate one member for the approval of the other party. The parties shall consult the selected two members and shall agree upon the third member who shall become the Chairperson. In addition to the required attributes described above, the Chairperson shall have the ability of running effective meetings in difficult situations.

Where to find a potential DB member? FIDIC provides for the List of President's Approved Dispute Adjudicators which is on its website¹⁰. Upon request, DRBF and ICC also will nominate or appoint DB members. The IDRC (International Dispute Resolution Centre) in Dublin, Ireland (part of the American Arbitration Association) has a list of persons suitable for DB work, as does the DBF (Dispute Board Federation). So, also, do the Institution of Engineers of Ireland and the UK ICE (Institution of Civil Engineers).

6. Cost of a DB

The costs for the DB process consist of two parts, one of which is the remuneration and reasonable expenses of the DB members and these costs are to be shared equally by the parties. The remuneration consists of the Monthly Retainer and Daily Fee. According to the General Conditions of Dispute Board Agreement of the FIDIC Red Book, a Retainer Fee per calendar month shall be considered as payment in full for, (i) being available on 28 days' notice for all Site visits and hearings; (ii) becoming and remaining conversant with all project developments and maintaining relevant files; (iii) all office and overhead expenses including secretarial services, photocopying and office supplies incurred in connection with his duties. A Daily fee shall be considered as payment in full for, (i) each day or part of a day up to a maximum of two days' travel time in each direction for the journey between the Member's home and the Site, or other location of any other meeting with the other Members; (ii) each working day on Site visits, hearings or preparing decisions; and (iii) each day spent reading submissions in preparation for a hearing.

Also, typically the Contractor provides local transportation for the DB to the Site, and if the Site is remote, will provide the DB with Site accommodation and meals, and the cost of this shared with the Employer. Recovery of the Employer's share typically is accomplished by including it in the next monthly progress invoice, or if there are stage payments, then by a separate invoice.

The other part is the costs to be incurred by the parties themselves. The Contractor shall pay for the costs of travel and accommodation for the company's staff to participate in the DB Site visits. If a referral is made and hearing is to be held, the Contractor shall pay for costs for preparation of position papers, the costs for obtaining the experts' opinion, if necessary, costs for the travel and

¹⁰ <http://www.fidic.org/>

accommodation of their company's staff and their experts to participate in or attend the hearing to be held at the Site. (Normally, legal counsel do not participate in DB hearings.) The Employer shall pay for the similar costs of its participation in the process, including those relating to the Engineer, who typically has a large involvement, including drafting Employer written submissions, arranging to obtain experts' opinions, and assisting at any hearing.

7. Conclusion

Too often, even though the contract calls for a DB, the parties see the DB as "too expensive" and because they have no disagreements at the beginning of the contract (the parties being "newly weds") so they postpone establishing the DB and say "We will establish the DB if we have a dispute which we cannot settle by friendly discussion." Or they establish the DB but insist that the DB Site visits be only annually, instead of quarterly, so they can "save money". These attitudes reflect lack of experience in use of DBs and lack of understanding that a properly established and maintained DB is one of the most valuable economies they can accomplish.

What happens if there is no DB? Typically when claims become serious disputes, both the Contractor and the Engineer begin exchanging elaborate claims documents, typically prepared with the help of consultants such as claims consultant companies, experts in delay analysis, independent specialists such as geologists or geophysicists, consulting quantity surveyors, and lawyers (both those internationally prominent and local lawyers of the country of the contract). All of these are expensive helpers! Those used by the Engineer of course are paid for ultimately by the Employer.

Preparation of these documents takes more than money, it takes a lot of time. Inevitably the documents must be reviewed by the parties' managements. Meetings to review and discuss the documents of both sides will be held, week after week, month after month, as the parties struggle with each other for victory without having to go on to the further expense and delay of arbitration. Typically, the struggle will continue even after construction has been completed. The Employer will have to keep staff of the Engineer working longer than the case if claims had been resolved by the time construction was complete. Similarly, instead of being able to release all staff to other projects, the Contractor has to keep its key Site staff involved, and if its camp has been demobilized, may have to find commercial office space, and may have to find rental accommodation locally for its claim staff. It is likely that some if not all of the experts who have assisted the parties in preparing the claims documents will be involved in these meetings. As with document preparation, if the experts are from outside the project country, significant transportation and accommodation costs are involved in attendance at meetings. Further, if eventually success is obtained in negotiating an

amicable settlement, a very large amount of senior management time will have to be devoted to those negotiations. Sometimes it is even necessary to employ a mediator to assist the parties, and to avoid arbitration.

Obviously, it is very difficult to budget for these costs. By contrast, a DB can be planned for and budgeted from the outset.

So let us turn to what happens if a DB is established at the outset and operated properly. The DB will be familiar with the contract from inception, and from its Site visits plus reading of regular written reports received between Site visits, the DB will be familiar with the progress of the construction. From experience on similar projects elsewhere, the DB will be alert to the principal areas of risk and potential problems. The DB will have the experience to assist the parties in avoiding conflict, and when disagreements do arise, in guiding the parties so that amicable settlement is achieved without elevating the disagreements into formal disputes. The most successful DBs are those which never have to deal with formal written submissions and hold hearings. Instead, using papers already in the hands of the persons doing the day-to-day management of the contract, and informal discussions, they can guide the parties to mutually acceptable resolutions. Typically, only the Site management staffs are involved with the DB, and the involvement of senior management of the parties is not required to reach resolution of disagreements on Site.

If for some reason a particular disagreement unavoidably becomes a formal dispute, the DB will be resolved to reach its own decision on the dispute quickly, and will control the production of documents to keep them to a minimum, keep any hearing to the minimum duration necessary to give each party a fair hearing, and then will prepare its decision under a time limit to which they are bound by their contracts with the parties. They will seek to give a unanimous opinion, and even if it is not fully acceptable to both parties, it very often forms the basis for further discussions and negotiations between the parties and leads to a settlement without either party initiating arbitration. Also, typically in contracts with DBs, all disagreements arising during construction will be resolved by the time construction is complete.

Clearly, the cost of a DB is a *saving* compared to the traditional end-of-the-contract battles over massive claims documents (and counter-claim documents!) dragging on many months after construction is complete.

Two Contracts and Three Arbitrations for One Incident



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ABSTRACT:

In a hydroelectric power plant project (HEPP) in an Asian country, the headrace tunnel was damaged and water leaked when pressurized as a test for completion. There was not only damage to the tunnel but the leaked water which caused landslide and the dirt dammed up the downstream of the river which flooded the power station.

The Employer and the Contractor had entered into a construction all risks policy of insurance. Parties (Insureds) notified the insurer of a claim under the Policy in respect of the cost of repair of the Damage. Meanwhile, the Contractor carried out the remedial works and the Employer paid for it.

The insurer declined to pay the claim on the grounds that the damage was due to the faulty design of the headrace tunnel and the cost of the repair of the damage was excluded from the Policy. The expert employed by the insurer stated that the failure was attributable to low horizontal stresses of the mountain allowing hydraulic jacking or fracture and that such failure was predictable and concluded that the design did not take risk of such failure into account.

This dispute went to arbitration. Meanwhile, there was another contract between the Employer and the Consultant who provided design for the project on behalf of the Employer. The Employer told the Consultant that if he failed in the arbitration with the insurer, he would seek for design liability of the Consultant.

The Consultant is covered by the Professional Indemnity Insurance (PI) with an insurer. This insurer has the intention to invoke arbitration arguing that the incident was not due to faulty design, if the Consultant claims the insurance when they (the Employer and the Contractor) failed in the arbitration with the insurer for the all risks policy.

What will happen if the Employer loses the arbitration with the Consultant? He may go to arbitration with the Contractor for his bad material and/or bad workmanship.

How to avoid such a risky situation as a contracting party?